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Minutes of Executive Board Meeting 87/148

10:00 a.m., October 26, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	W. K. Parmena, Temporary
	Jiang H.
C. H. Dallara	M. K. Bush
J. de Groote	G. Seyler, Temporary
	M. Hepp, Temporary
M. Finaish	M. B. Chatah, Temporary
	B. Goos
	K.-H. Kleine, Temporary
J. E. Ismael	J. Reddy
	J. Hospedales
	M. Foot
	G. D. Hodgson, Temporary
	C. V. Santos
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
	M. Fogelholm
	I. Puro, Temporary
	D. Marcel
	G. P. J. Hogeweg
	C.-Y. Lim
	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
	M. Sugita
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. J. Primorac, Assistant

Also Present
IBRD: J. Ingram, Africa Regional Office. African Department: G. E. Gondwe, Deputy Director; E. L. Bornemann, J.-C. K. Brou, E. A. Calamitsis, R. E. Daumont, M. deZamaroczy, A. Doizé, Y. Fassassi, J. G. Keyes, P. H. Mathieu, E. Sacerdoti. Exchange and Trade Relations Department: H. B. Junz. External Relations Department: B. J. Mauprivez. Legal Department: F. P. Gianviti, General Counsel and Director; T. M. C. Asser, H. Elizalde, P. L. Francotte, R. H. Munzberg. Secretary's Department: C. Brachet, Deputy Secretary; S. Woolls. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, B. E. Keuppens, D. V. Pritchett, G. Wittich. Office of the Managing Director: R. Noë, Internal Auditor; C. P. McCoy, R. H. Ronneberg. Advisors to Executive Directors: P. D. Péroz, G. Pineau, N. Toé, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, E. C. Demaestri, F. Di Mauro, S. K. Fayyad, S. Guribye, G. K. Hodges, L. Hubloue, S. King, V. K. Malhotra, T. Morita, D. V. Nhien, C. Noriega, L. M. Piantini, S. Rebecchini, A. Rieffel, S. Rouai, V. Rousset, C. Sel, H. van der Burg, E. L. Walker.

1. SENEGAL - STAND-BY ARRANGEMENT; AND STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff paper on Senegal's requests for a stand-by arrangement and for a second annual arrangement under the structural adjustment arrangement approved November 10, 1986 (EBS/87/205, 10/1/87), together with a policy framework paper (EBD/87/245, 9/29/87).

The Acting Managing Director made the following statement:

> There follows for the information of Executive Directors the text of a memorandum that I have recieved from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their October 20, 1987 discussion in Committee of the Whole of a paper entitled "Senegal: Policy Framework Paper, 1987/1990."
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> 1. The Executive Directors generally commended Senegal for its sustained adjustment program. The strict implementation of demand management programs have helped the country achieve much better macroeconomic balance, including lower fiscal and current account deficits and reduced inflation. Real economic growth has also picked up in the past two years, thanks in part to more normal weather. The Directors noted the progress achieved in the implementation of SAL III and hoped that timely implementation of key measures would continue.
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> 2. Four major concerns were raised by Directors, i.e.:
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> (a) exchange rate policy and the prospects for growth and export diversification;
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> (b) agricultural pricing policy, particularly for rice;
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> (c) industrial restructuring plans including public enterprise reform, privatization, banking sector and tariff reform; and
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> (d) energy pricing and development policy.
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> 3. The issue of the CFA franc exchange rate was raised as of prime concern to the realization of export growth and diversification. Several Directors inquired about the impact of the export subsidy scheme which was recently revamped to better encourage exports. Its functioning is now being reviewed by the Government under SAL III. A Director suggested that given the limitations on the use of the exchange rate as a policy instrument, a temporary import surcharge may be necessary to allow

Senegalese enterprises to adjust to the trade liberalization process. Another Director agreed but felt that this would be very much a second best solution compared with an adjustment in the exchange rate itself. Maintenance of adequate incentives for exports would be critical. In this regard, labor legislation needed to be carefully reviewed to ensure that it does not lead to uncompetitive labor costs and rigidities in the labor market.

4. Industrial restructuring was seen as a critical but difficult issue. Some Directors raised the question of whether and how quickly private investors will be forthcoming to take over activities which are being privatized under the parapublic sector reforms. The staff noted that, in view of the fact that the process of privatization is only about to begin, it may be too early to assess the response from potential investors. Job losses from reforms in the industrial sector are another area of concern. The creation of the social fund to help redundant workers start small businesses is considered a step in the right direction to facilitate the adjustment process. However, it was also noted that attempting to completely alleviate the problem of job losses through such a fund was beyond the resources available to Senegal.

5. Reform of the public enterprise sector is a critical priority for strengthening the government budget, the financial system, and the private sector. Several Directors inquired about the status of the banking sector reforms, noting the importance of financing intermediation in the development process. Tariff reform was also considered a high priority.

6. Rice price policy in Senegal was also seen as critical. A careful balance would have to be maintained between the interests of rice producers and other farmers and those of rice consumers. The exchange rate of the CFA franc zone would also have an important impact on agricultural prices.

7. Several Directors noted that energy prices were relatively high since they did not reflect the decline in the world price of oil in the last 18 months. While this price policy has certainly contributed to strengthening public finances, its possible disincentive effects on industrial development would need to be watched. The staff also noted that development of potential hydroelectric projects and increased efficiency in the energy sector might help reduce energy costs.

8. Senegal's heavy burden of debt servicing, particularly when expressed in relation to the Government's fiscal revenues, was noted by a Director. He suggested that further effort should be made by the donors to help alleviate this burden. The Directors

concluded by recommending that adequate financial support should be provided to allow Senegal to continue with its adjustment efforts and to alleviate its heavy debt burden.

Mr. Santos made the following statement:

On March 25, 1987 the Executive Board had the opportunity to review recent economic and financial developments in Senegal in the context of the midterm review of the 1986/87 program and the Article IV consultation discussions. On that occasion, Directors were informed of the generally good economic performance registered in 1985/86 and the steady progress being made toward reducing the country's internal and external financial imbalances. Based on available information, an equally satisfactory economic and financial performance is estimated to have been recorded in 1986/87. Most of the program's objectives were achieved, with the external position improving more than was expected. At end June 1987, all the performance criteria were observed and Senegal made all the scheduled purchases under the stand-by arrangement, prompting the authorities to cancel it on September 28, 1987. In addition, all but one of the benchmarks pertaining to the first annual arrangement under the structural adjustment arrangement were observed. The nonobservance of the structural benchmark on the action program for agricultural prices is attributable to factors beyond the authorities' control, namely, the delays in finalizing the agreement with the donors and the need to broaden the terms of reference of the study to be undertaken.

As mentioned in the letter of intent, the authorities recognize that notwithstanding the steady progress made in many areas over the past several years, serious structural and financial difficulties persist, which are hampering the attainment of a sustainable noninflationary growth. Determined to remove these structural impediments, the authorities have decided to pursue their adjustment efforts in the context of an updated and extended medium-term framework covering the period 1987/88-1989/90. In this connection, they are requesting the second annual arrangement under the structural adjustment arrangement and a one-year stand-by arrangement. The objectives of the three-year program and of the adjustment program for 1987/88 to be supported by the requested arrangements, together with the policy measures for achieving these objectives, are spelled out in detail in the policy framework paper (EBD/87/245, page 5) and the staff report (EBS/87/205, pages 17, 18, and 23). Therefore, I need not elaborate on them; I would rather highlight a few areas in which the authorities intend to introduce corrective measures and intensify their effort in 1987/88. The areas covered are: pricing policy, domestic public resource mobilization, the reform of the public enterprise sector, and the rehabilitation of the banking sector.

The sharp decline in world market prices for edible oils in the face of the Government's remunerative producer pricing policies has led to a substantial deficit in the financial operations of the groundnut sector and underscores the need to strike a balance between minimizing this deficit and maintaining adequate incentives to groundnut producers. It is our authorities' belief that the success of the new agricultural policy will hinge critically on the manner in which such a balance is struck. In its report, the staff has rightly stressed the importance of a timely determination of producer prices for the coming crop season. The authorities are fully aware of this and are committed to taking suitable action, at the appropriate time, on the basis of the recommendations that will be made following the completion of the study on agricultural prices, and in the light of development in world market prices for edible oils.

The authorities face another dilemma with respect to their pricing policy for petroleum products. On the one hand, there is the need to maintain a structure of retail prices that restrains energy consumption while mobilizing, for the budget, the windfall profits resulting from the price differentials. On the other hand, there is the need to preserve the competitiveness of the export-oriented enterprises by providing them with energy at prices which are comparable to that of their competitors and reflect world oil market prices. The authorities have decided to keep energy prices unchanged so as to generate and mobilize the windfall profits to strengthen the fiscal position in 1987/88.

The 1987/88 program contemplates a 6.5 percent increase in total revenue with a projected increase of 8.2 percent in tax revenue. To achieve this target, the authorities are following a two-pronged approach of broadening the tax base and strengthening tax administration. As described in the staff report on page 30, the numerous actions envisaged in 1987/88 to broaden the tax base include: the adoption of a new customs code that will facilitate law enforcement; the initiation of the first tranche of the program of sales of state-owned land; the introduction of a fiscal cadastre in the Dakar area and a partial computerization of urban tax assessment; and the launching of studies on the extension of the coverage of the value-added tax to the commerce and the services sectors, and the substitution of a global income tax system for the secular income taxes.

The measures to improve tax administration include the restructuring of the customs and tax departments to reinforce the auditing and cross-checking functions, a computerization of assessment and collection procedures, and a strengthening of the control of customs valuations. The authorities have established performance indicators to help them closely monitor the implementation of the various measures geared at raising budgetary revenues.

The authorities recognize the need to accelerate the pace of implementation of public enterprise sector reform. In addition to the measures taken earlier to that effect--appointment of a high government official to oversee the reform process, improvement in management, and staffing of the restructuring agencies--they are devising new procedures that will lay the ground for future divestiture. In the meantime, the Government has made progress in arranging for the sale of the shares of a first group of 10 enterprises selected for privatization. In 1987/88, the Government will reach agreement on 12 contract programs with the enterprises that will remain in its portfolio.

The financial rehabilitation of the banking system will be given high priority in 1987/88. For the three institutions experiencing major difficulties--Union Sénégalaise des Banques pour le Commerce et l'Industrie, Banque Commerciale du Sénégal, and Banque Nationale de Développement du Sénégal--actions ranging from the implementation of a rehabilitation program to liquidation and replacement by a new institution have been already taken. The authorities intend to address the problems facing the banking system at large in the context of a sectoral meeting being prepared with assistance from Senegal's major creditors and donors.

In sum, the authorities are encouraged by the positive response of the economy to the adjustment measures they have been implementing over the past several years. They agree with the staff that the implementation of appropriate structural and financial policies, the timely disbursement of external financial assistance, and the return to good weather conditions have played a central role in bringing about the marked improvement in Senegal's economic and financial performance. They are determined to continue their efforts and hope that the international financial community will continue to support these efforts. In addition, increased and timely concessional external assistance and debt relief will be required to close the prospective fiscal and external gaps and provide support to Senegal's growth-oriented adjustment strategy.

Extending his remarks, Mr. Santos said that his statement might have given the wrong impression that the Senegalese authorities had canceled the previous stand-by arrangement because all the scheduled purchases had been made. Actually, the main reason for the cancellation was the fact that all the objectives of the program had been achieved, and the authorities wished to begin another stand-by arrangement before the previous one expired.

Mr. de Groote made the following statement:

The simultaneous discussion of Senegal's economic program by both the Executive Directors of the World Bank and of the Fund highlights the importance of joint Fund-Bank action; the program which we are asked to approve today is a successful confirmation of the joint Fund-Bank structurally oriented policies that the authorities have been implementing since mid-1983. These parallel efforts on both external adjustment and internal development issues have been increasingly acknowledged by the international donor community, as witnessed by the constructive dialogue and positive solutions arrived at during recent donor meetings. The fact that these meetings relied greatly on the investment and development programs embodied in today's policy framework paper also illustrates that the enhanced policy dialogue elicited by the policy framework process can be a highly rewarding exercise.

The simultaneous discussion in both boards of the policy framework paper is also highly relevant to the close interrelationship between Bank and Fund policies in Senegal's adjustment policy. Of particular importance in this context is the assessment, by both institutions, of the policy adjustments to be taken by the authorities in the light of the exchange rate limitations imposed by their membership in the franc zone. The need to reconcile the prescriptions of further liberalization and financial stabilization with the equally justified objective of reallocating resources away from imports and toward exports is particularly demanding in the context of these limitations. The observations that I submitted in the statement I circulated for the discussion of Senegal's policy framework paper in the World Bank Board on October 20, 1987, are intended to activate our dialogue with the authorities on this issue and to seek further guidance from the staff of both institutions.

The text of my statement read as follows:

I would like to begin by commending the staff on its excellent work, then to comment on some specific points which we consider important to this program.

Senegal's recent economic history shows steady and substantial progress toward economic recovery and financial adjustment resulting from the program which the Senegalese authorities have been implementing since 1983. Because of the magnitude and duration of the decline in primary commodity prices, however, Senegal still has a long way to go toward completion of its adjustment process. As is clearly stated in the report, major structural and financial problems still exist: the economy is fragile and vulnerable to external shocks, inflation is relatively high, and the internal and external imbalances are still unsustainably large. The overhang of domestic arrears is still a problem; the financial position of most public enterprises is worrisome; a number of commercial and development banks have a large amount of nonperforming loans creating severe liquidity problems; and Senegal's debt service obligations are large.

The paper before us proposes a comprehensive program to address these problems and overcome these difficulties. Its basic objectives, which include attainment of a real growth rate high enough to improve real per capita income, further reduction of the inflation rate, and continued improvement of Senegal's balance of payments position, are well chosen, as are the means. These include continuing to promote private sector initiatives, encouraging the efficient utilization of resources through appropriate pricing and other incentive programs, the pursuit of greater efficiency in public resource management through better allocation and implementation of public investment, the reform of public enterprises, and strengthening of public finances, all of which we believe deserve special attention.

The priorities set for the public investment program seem very appropriate; the systematic review of public investments should be attractive to donor support. We see a need, however, to carefully manage the decentralization of project preparation and implementation to avoid the possible difficulties which are likely to result from a lack of qualified personnel.

In the agriculture sector, the measures for promoting domestic cereal production, the privatization of internal marketing and cereal imports, and the decontrol of the importation and marketing of agricultural imports are very much in line with the general objectives and strategies of the program. Domestic production needs to be expanded and diversified to increase exports and reduce reliance on imports. We therefore applaud the Government's commitment to decrease its intervention by privatization and the elimination of subsidies. The abandonment of rigid pricing and trading arrangements will permit producer prices of cereals to be based on economic factors, promoting efficient allocation and utilization of resources.

The development of local energy sources, restraining energy consumption by appropriate pricing policies, and expanding the revenue base and increasing tax yields, lower public enterprise subsidies, and the reform, privatization or liquidation of public enterprises are all crucial steps toward adjustment.

In the industrial sector, the measures aimed at improving competitiveness, promoting exports, and making enterprises more fully responsible for their business decisions, while at the same time reducing the cost to the Government of industrial incentives, are also very much in line with the spirit of the program. In addition, eliminating the presently existing bias toward capital intensive projects might also help alleviate the unemployment problem, and we see the revision of the investment code as a welcome step in this direction.

Trade liberalization has traditionally appealed to this chair as a key element of any adjustment package, on which the success of programs greatly depends. In Senegal's case, however, we see some possible risk connected with a trade liberalization program, consisting of the removal of quantitative restrictions and the rationalization of the tariff structure. Such measures must be applied cautiously because in the case of Senegal it is not feasible to accompany them with adjustments in the nominal exchange rate. No doubt the real exchange rate has now adjusted moderately in the needed direction, and we all recognize the advantages associated with membership in the franc zone--advantages such as free access to reserves, cooperative credit margins, a continuous policy dialogue on the appropriateness of development strategies and the general benefits of exchange rate stability for investment decision and for the avoidance of speculative movement. The situation in the French franc area is therefore recognized as more favorable in general than in other countries in similar circumstances. This membership in a zone of fixed exchange rates has, however, implications in terms of the choice of appropriate policy instruments.

Some ways of compensating for the limitations on the use of the exchange rate instrument do exist. During the liberalization and industrialization process, additional import duties might temporarily have to be levied, though this tends to reverse the liberalization process itself. One could also consider temporary export subsidies, though this places some additional burden on public expenditure. Care must therefore be taken to apply these options only on a temporary basis so as not to undermine the overall adjustment process. The Senegalese authorities have for more than a year been using measures aimed at compensating for the inflexibility of the nominal exchange rate. A very recent example is the "drawback" scheme, which refunds duties paid on imports if it can be shown that they have been used as inputs to export production. Another example, in longer use, is the widespread application of export subsidies in the industrial sector. The method of calculating these industrial export subsidies was recently changed from an f.o.b. value to a value-added basis, a change which is expected to enhance the overall impact of the subsidies. The Bank looks more favorably than the Fund on these kinds of measures. If we can make sure, on the occasion of our periodic consultation with Senegal, that these measures are only to be applied during a transition period, it is my view that they could be accepted as the unavoidable corollary of Senegal's exchange system.

In sum, we consider that the program outlined here deserves donor support. We hope the courageous efforts of the Senegalese authorities to implement the program will receive timely and adequate support from the donors and other concerned authorities, and of course, that they will be aided by favorable exogenous factors, both economic and climatic. Finally, I would like to thank the staff for their precise and careful answers to the technical questions we raised prior to the Board meetings, and ask the Executive Director for Senegal to convey to the Minister of Finance, our former colleague Mamoudou Touré, all my best wishes for success.

Mr. Kabbaj made the following statement:

The adjustment process in Senegal, initiated in 1979, remains difficult and will probably take longer than originally expected. This indicates that the Senegalese economy's difficulties were not strictly of a balance of payments nature, but rather were deeply rooted in the economic and financial systems, as evidenced by the wide range of structural reforms being implemented or contemplated by the present program.

However, it is heartening to note that despite the unfavorable external environment which prevailed in recent years, substantial progress has already been achieved, thanks to the commitment of the authorities to steady adjustment. In this respect, while the results in 1980-82 were not quite sufficient to sustain an economic recovery, the progress achieved since 1983 is promising. The overall fiscal deficit was reduced from 8.2 percent to only 2.3 percent of GDP between 1982/83 and 1985/86. In the same period, the external current account deficit declined from 21 percent to 15.6 percent of GDP, and GDP growth recovered after two years of decline, reaching 4.2 percent. The authorities are to be commended for their efforts to eliminate external and internal arrears despite the severe constraints on their budgetary resources.

Such improvements were attributable not only to better weather conditions but also to the firm implementation of supply-side and demand-management policies. In this regard, the authorities strengthened incentives to the agricultural and industrial sectors and introduced a set of reforms to liberalize the economy, reduce the role of the public sector, and improve the banking system. As a result, all performance criteria set by the previous program were observed.

Notwithstanding these achievements, the authorities are aware that the economy remains highly vulnerable to exogenous factors, including weather conditions, terms of trade, and external financing. They also recognize that further improvements are still required to curb inflation and reduce internal and external financial imbalances. In this respect, the Government's intention to pursue its adjustment program in a medium-term context while introducing the required corrective measures is welcome.

The policy framework paper, as updated for the period 1987/88-1989/90, is comprehensive and highlights the magnitude of the task to be achieved by the authorities. The main objectives are: real annual GDP growth rate of 3.8 percent; reduction of the inflation rate by about 2 percentage points; reduction of the current account deficit from 10.8 percent of GDP in 1986/87 to 7.3 percent of GDP in 1989/90; and achievement of an overall fiscal surplus by the year 1988/89.

Firm implementation of the actions programmed would help the authorities achieve a sustainable economic growth and would improve the country's per capita income. However, given the magnitude of the financing gap and the growing burden of the external debt, further concessional external assistance and appropriate debt relief would be necessary to support the country's efforts during its adjustment process.

Senegal's medium-term balance of payments outlook appears somewhat fragile. The baseline scenario, with the objective of attaining a viable external payments position toward the end of the decade, remains very sensitive to changes in domestic adjustment policies and in the external environment, not to mention the direct impact of weather conditions which alone could hamper the adjustment process. In this respect, Scenario A illustrates this fragility well; a 1 percent change in the average annual growth in imports and exports volume during the period 1987/88-1989/90 would postpone the attainment of a viable balance of payments situation, worsening the current account deficit by about 1 percent and increasing the financing gap by 72 percent.

I support both proposed decisions.

Mr. Parmena made the following statement:

We warmly support Senegal's requests for a stand-by arrangement and for the second annual arrangement under the structural adjustment facility. It is evident from Table 3 of the staff paper that Senegal has undertaken significant adjustment in recent years, as reflected in the improvement in the savings ratio and the narrowing of the budget and external current account deficits. More important, there appears to have been some progress in the real sector of the economy. The recovery, which began in 1985/86 after two years of economic decline, was sustained in 1986/87 and is likely to continue in the current year. Since I am in general agreement with the thrust of the program, I will restrict my remarks to a few broad topics. I will begin with the question of financing, followed by brief comments on two issues of program design, and will then make some observations on the medium-term outlook.

It is evident that assistance from the Fund is only a small part of the program's financial requirements. Taking into account scheduled repayments, net inflows from the Fund (including the drawing under the structural adjustment facility) are only about SDR 9 million. This means that the Fund's role is minimal and, therefore, the implication is that it will play mainly a catalytic role, with financing from donor countries playing the pivotal role. In situations of this kind, the Fund should take an active part in mobilizing the requisite resources, especially for countries which have experienced difficuly in attracting concessional inflows. In the staff paper, emphasis is given to the importance of rescheduling and of the need for external assistance to be provided increasingly in the form of grants. I agree fully with this suggestion, but would go further and note that debt relief might also include the reduction of Senegal's current debt-servicing burden. Interest payments due in 1987/88 are about 85 percent of the current account deficit, and are expected to exceed the current account deficit in each of the next three years. Given the need in Senegal to create ample room for maneuver, because of the vulnerability of the economy to exogenous developments, a strategy to reduce interest payments deserves serious consideration.

We think that a comprehensive adjustment program with the potential for good results can be devised even where there are constraints on the use of the exchange rate as a policy instrument, as in Senegal. However, it does appear that greater weight must be placed on fiscal management in order to hold the various elements of the adjustment strategy together. There is much to be said for a program like Senegal's that attempts to strike a balance between policy reorientation and project development. The pendulum of donor lending is beginning to swing too much toward policy-based adjustment programs and away from the more traditional project lending, and there is some concern as to whether the former, in and of themselves, are sufficient to build up the resilience of developing countries to exogenous shocks, and whether such programs would place countries in a better position to service their external debts. I submit that sound macroeconomic policies are essential for successful adjustment, but it is also true that for many developing countries there can be no substitute for well-conceived development projects in areas such as agriculture, transportation, energy, and manpower development.

The decline in gross capital inflows and the rise in interest payments projected for the period 1987/88-1990/91 seem to be incompatible with the adjustment effort in Senegal. It is now widely agreed that the debt burden of low-income countries must be reduced substantially and capital inflows increased if those countries are to implement a smooth process of adjustment that can be sustained at the political level and that is geared toward achieving some measure of financial stability and long-term growth.

Mr. Kleine commended the authorities for the continued progress made toward economic and financial adjustment in 1986/87; Senegal was another fortunate example of the combination of adjustment and growth. But notwithstanding the considerable progress registered in recent years, Senegal still faced major structural and financial problems. It was therefore encouraging that the authorities remained determined to maintain their adjustment effort in close cooperation with the Fund, the World Bank, and bilateral donors. Their effort deserved the continued support of the international financial community, not least because of the good track record of the country. Given reasonable assurances that the financing necessary for the program would be forthcoming, he could support an outright approval of Senegal's request for use of Fund resources.

Since he was in general agreement with the staff's assessment and recommendations, his additional comments would be brief, Mr. Kleine said. There were cases in which some form of regional surveillance might be helpful or even necessary for an appropriate assessment of economic developments and prospects in individual countries. Senegal was a good example in that respect, given the country's close competition in agricultural trade with The Gambia, Guinea-Bissau, and other neighbors. Therefore, Fund arrangements with member countries in that area should perhaps pay more explicit attention to interregional production and trade relations, particularly with respect to groundnut operations. Since several countries in the region had arrangements with the Fund under the structural adjustment facility, those arrangements could be a particularly helpful instrument for effecting regional surveillance with a view to achieving a better harmonization of national policies in the area. In any event, the authorities should carry out the postponed study on the determination of producer prices of cereals as a matter of the highest priority and take the requisite pricing action without undue delay.

Mr. Kleine endorsed the staff appraisal and supported the proposed decisions.

Mr. Finaish made the following statement:

> The authorities are to be commended for implementing a wide range of corrective structural and demand-management policy measures, which have contributed importantly to a marked recovery of the economy over the past two years. In the context of successive Fund-supported programs since mid-1983, significant progress has been achieved in liberalizing the economy, strengthening agricultural and industrial production incentives, reducing the Government's overall fiscal deficit, and improving the external current account position. In addition, Senegal's progress toward financial stability has been accompanied by a reduction in the substantial gaps between urban and rural incomes.
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> However, because of its economic structure, Senegal remains highly vulnerable to adverse weather conditions and movements in the international terms of trade. Furthermore, the country's heavy external debt burden continues to constrain its growth potential and exert pressures on government finances and on the balance of payments. In these circumstances, the authorities did well to recognize the need for the comprehensive adjustment measures outlined in the medium-term policy framework paper, which they have revised and updated in close collaboration with the staffs of the Fund and the World Bank. The implementation of these measures, in support of which the authorities are requesting use of Fund resources, should permit an orderly continuation of the adjustment effort undertaken by the authorities in the context of previous Fund-supported programs.
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> The adjustment program for the fiscal year 1987/88, to be supported by the requested stand-by arrangement and the second annual arrangement under the structural adjustment facility, consists of a wide range of financial and structural policy measures that rightly emphasize the need to alleviate growth-impeding structural weaknesses while restraining aggregate demand in order to prevent it from spilling into the external sector. Consistent with this overall objective, the contemplated ajustment measures focus on promoting private sector initiative

and efficient utilization of resources through appropriate pricing and other incentive policies, and on achieving greater efficiency in public resource management through improvements in the allocation and implementation of public investments, reform of the parapublic sector, and strengthening of government finances.

The baseline scenario for the balance of payments indicates that on the basis of the policy measures envisaged in the program, Senegal could attain a viable external payments position by the end of this decade. However, as the staff illustrates under the alternative scenarios, the balance of payments outlook is sensitive to changes in the external environment and in domestic adjustment policies. It is therefore of the utmost importance that the authorities persevere in their adjustment effort and rigorously implement the contemplated reforms. It is equally essential to the success of Senegal's growth-oriented adjustment strategy, especially in view of the prospective fiscal and external gaps, that the projected flows of external assistance be realized and that disbursements be made in a timely manner.

The comprehensive set of policy measures to be enacted over the program period reflect the authorities' determination to move Senegal's economy onto a path of sustained economic growth. We also feel that the proposed program is well thought out and consistent with the achievement of the policy objectives set out in the medium-term policy framework paper. Accordingly, we support the proposed decisions.

Mr. Hodgson made the following statement:

Senegal has been using Fund resources almost continuously since 1979, and the program we are considering today will be, I believe, the eighth Fund arrangement for Senegal over that time frame. In a number of other sub-Saharan African countries, prolonged use of Fund resources has raised serious concerns and has not contributed to any significant improvement in the economic situation, but fortunately, current circumstances appear to be more favorable for Senegal. Policy implementation since 1983 has been stronger and more consistent than before, and the improved policy environment is finally beginning to bear fruit in terms of economic performance.

It is against this background that we support the requested stand-by arrangement and the second disbursement under the structural adjustment arrangement. We view the mix of resources being provided under these two arrangements as appropriate. While total Fund resources outstanding will increase slightly under the program, there will be reduced reliance upon tranche resources and a shift toward more favorable financing terms available under the structural adjustment arrangement.

The adjustment program itself is far-reaching and touches on nearly all significant aspects of economic management. It might be argued that by concentrating on only a few key areas for reform, the program might ensure greater chance of success. However, Senegal's recent positive track record, and the need to refine structural policy reforms in a number of areas while further strengthening demand-management policies, suggest to us that the comprehensive nature of the program is both necessary and attainable. Indeed, if the authorities can fully implement this program, there are good prospects for a return to balance of payments viability, with growth, by the end of this decade. That would be a welcome accomplishment within the region, and I urge the authorities to continue building the political support needed for full implementation.

More specifically, we can fully endorse the staff's three priority areas: first, an action plan for producer prices for the 1988/89 crop season; second, vigorous pursuit of fiscal adjustment; and third, strengthened reforms in the financial sector. In each of these areas, further reforms in the underlying institutions will be needed to support the policy adjustments which have already been made. In the groundnut sector in particular, a careful balance needs to be struck between reducing subsidies to producers and maintaining adequate incentives over time. I would be interested in staff views on other institutional changes that might be considered over the medium term, such as income stabilization or insurance schemes financed by the producers themselves.

We are pleased by continuing efforts to liberalize economic decision making, and reduce protection of various sectors, and by the plan to remove most price controls by the end of 1988. These reforms are being extended into the parastatal sector, and we endorse the authorities' plan to rationalize and privatize key public enterprises. The goal of eliminating government subsidies to parastatals by 1989/90 should be an outside limit, and action in this area should proceed more quickly if possible.

Mr. Marcel made the following statement:

We fully support the two proposed decisions. The policies supported by these two facilities are part of a general strategy that we have already reviewed and endorsed during previous meetings, so we have no difficulty in repeating this support in such areas as agricultural, industrial, and energy policies.

I shall focus my comments on the issue on which the 1987/88 program puts a new or an increased emphasis: first, the groundnut sector; second, the Government's revenue mobilization and expenditure control; third, the rehabilitation of the banking sector. Finally, I will say a few words on the financial assistance extended by the Fund.

Regarding the groundnut sector, we fully share the concerns expressed in the staff report regarding the 1986/87 crop deficit. We welcome the authorities' commitment to adjust the producer price for the next crop, should present world market conditions remain unchanged. The restructuring of SONACOS, for which an action plan will be prepared by end-March 1988, will also be an essential contribution to this sector's financial rehabilitation.

Regarding fiscal policy, while the staff report recognizes the progress made in strengthening revenue collection, controlling expenditures, and reducing domestic arrears, the budget deficit remains a matter of concern; all the more so because, in spite of the measures already implemented, tax revenues have decreased from 18 percent of GDP in 1983/84 to 14.5 percent in 1986/87. This is excluding receipts from the oil sector which will need to be substituted in the medium term by a more stable and permanent source of resources. Therefore, we welcome the supplementary efforts described in the letter of intent to increase tax revenues by 8.2 percent in 1987/88.

Regarding expenditures, given the relative importance of the wage bill--over 50 percent of current expenditures is on wages--its monitoring will need to be improved in order to remain within the 2.1 percent increase scheduled for the next fiscal year.

On the banking sector, the estimated amount of nonperforming loans, more than 25 percent of the claims on the private sector, gives an idea of the seriousness of the situation. Given the emphasis placed by the Senegalese program on the role of the private sector, the success of the industrial policy will to a large extent depend upon the efficiency of the financial sector. Therefore, we fully encourage the Government to design viable longer-term solutions for the rehabilitation of this sector in addition to the measures already under implementation. We feel that on the basis of a credible plan of action, the authorities should be in a position to mobilize the assistance required by this objective.

Finally, regarding Fund assistance, my authorities welcome the continuing support extended by the Fund through the combination of a stand-by arrangement and an arrangement under the structural adjustment facility. We believe that stand-by arrangements or extended facilities should remain the usual mode of intervention of the Fund in countries like Senegal. In this context, resource flows from the structural adjustment facility should be additional to these normal resources and not be substituted for them.

Mr. Al-Assaf made the following statement:

The 1987 Article IV consultation which took place last March provided a number of indications that, after an extended period of stagnation and mounting structural difficulties, Senegal's economy was making solid gains in some key areas. The papers before us today further support this view. They also demonstrate that the achievements of the last few years have been due mainly to the implementation of more appropriate economic and financial policies. The authorities are determined to stay on that course, and should be commended for their determination as well as their recent achievements. The proposed stand-by arrangement, together with the second annual arrangement under the structural adjustment facility, are intended to maintain the momentum of the current adjustment process. Therefore, I have no difficulty in supporting the proposed decisions.

The example of Senegal is worthy of some general remarks that may be of relevance to other cases in Africa. First, the capacity of African countries to adjust, even if not in a situation similar to that of Senegal around 1980, should not be underestimated. Second, the expected speed of adjustment should not be unrealistic. Had this view not been heeded in Senegal when the first adjustment efforts faltered in the early 1980s, the improvements now under way might not have materialized. Third, at least in the absence of exceptionally adverse circumstances, adjustment and growth objectives can be achieved simultaneously over the medium term. Finally, the lengthening of the adjustment process need not involve a comparatively greater cumulative use of the Fund's resources. As a matter of fact, the two proposed arrangements we are discussing today will result in almost no increase in net credit outstanding and, on the contrary, will be accompanied by a decline in the use of Fund credit under the tranche policies.

Turning now to the substance of the proposed adjustment program, I will limit my comments to a few points, since I am in broad agreement with the views expressed by the staff.

First, in view of the continued weakness and vulnerability of the balance of payments, the maintenance of an adequate degree of external competition will be essential. The constraints placed on Senegal, as a member of the West African Monetary Union (Union Monétaire Ouest Africaine - UMOA) are, of course, limiting the authorities' room for maneuver in the area of the exchange rate. Keeping inflationary pressures under control will play an essential role in this regard.

Second, fiscal policy should give top priority to the achievement of fiscal adjustment. The broadening of the tax base included in the scope of the program is a step in the right direction, but adequate control of expenditures, including extrabudgetary expenditures, is probably even more important.

Third, the question of the soundness of the banking system needs to be addressed forcefully. The current absence of a long-term solution to the difficulties of various commercial and development banks introduces an element of uncertainty. This runs at cross-purpose with the authorities' efforts to restore confidence and stability in the economy.

Finally, I would like to emphasize the point made by the staff about the need for continued external assistance. I hope that it will be forthcoming, and I wish the authorities well.

Mr. Puro commended the authorities on their adjustment policies and on the progress made in reducing their country's internal and external financial imbalances. However, notwithstanding the recent positive outcome, the country still faced major structural and financial problems. In the circumstances, the revised program seemed to be an appropriate method by which to approach macroeconomic balance in the medium term. Nevertheless, he had concerns regarding intended policies in two areas.

First, by tying its monetary and exchange rate policies to the UMOA, Senegal might have largely ruled out the use of the exchange rate as a policy instrument, Mr. Puro said. How beneficial could such an arrangement be over time? The authorities could perhaps gain more from having monetary and exchange rate policy instruments in their sovereign policy arsenal. With tied exchange rate policies, there was the danger that the exchange rate would have to be supported by artificial devices, such as an import surcharge, which would tend to increase distortions in the incentive structure of Senegal's economy.

His second area of concern was energy prices, Mr. Puro continued. The appropriateness of the authorities' 1987 decision to subsidize the energy costs of certain export-oriented enterprises, as well as the optimality of their intention to continue the policy of unchanged energy prices, were questionable. That policy could have serious repercussions on competitiveness and on incentives related to export-oriented enterprises. It might also send misleading signals regarding the allocation of resources to the potential development of hydroenergy. Moreover, rigidity in energy pricing hardly answered the need for increased flexibility in the economy and for gradual introduction of more market-oriented elements.

Despite those concerns, his overall evaluation of the medium-term program was positive, Mr. Puro indicated. Furthermore, experience to date had proven that the authorities were strongly committed to the prompt implementation of their strategy. Considering the recent adjustment record, Senegal had a good case for debt relief. It was obvious from the staff report that the country could not succeed without outside assistance. The international community, and donor countries in particular, ought to see to it that adequate financing for Senegal was available. It was hoped that they were prepared to carry out their part in facilitating Senegal's adjustment, and that fruitful cooperation would continue to the mutual benefit of all parties, especially that of Senegal.

Mr. Puro supported the proposed decisions.

Mr. Dallara commended the authorities for the considerable progress they had made over the past three to four years. That progress had included both identifying obstacles to growth and balance of payments viability, and outlining policy measures necessary to overcome those obstacles. The Fund and the World Bank had both played important supportive roles in that process.

Nevertheless, he had some concern over Senegal's continuing reliance on a widespread system of controls that sustained a rather high degree of government involvement in the economy, Mr. Dallara indicated. Certainly, the efforts to date and those planned in the policy framework paper, the stand-by arrangement, and the structural adjustment arrangement suggested a continuing effort to reduce those controls, but the management skills and institutional capacity of the country were such that it could achieve its economic objectives more quickly by accelerating the pace at which the role of the private sector was increased. In addition, Senegal's reliance on a continuing series of Fund stand-by arrangements seemed rather extensive.

The policy framework paper was comprehensive and informative, and he supported the objectives outlined therein, Mr. Dallara said. However, the lowering of the current account target from a deficit of 6.6 percent of GDP for 1988/89 to 7.3 percent for 1989/90 seemed excessive. It was also disappointing that the first-year structural adjustment arrangement benchmark regarding the study of agricultural prices and other incentives had not been met. That had resulted in a whole year being lost in setting more appropriate producer prices. The authorities should work toward reducing, and indeed eliminating, reliance on stand-by arrangements in the not too distant future, particularly as the adjustment effort continued to pay dividends, and in light of the support which could be provided by the Fund through the structural adjustment facility.

In the policy framework paper, the listing of the many problem areas which would require a high level of attention during the period ahead was welcome, Mr. Dallara said. However, a short analysis of how the tackling of those problems would fit together and help achieve the objectives of the program would have been useful.

Table 2 included the objective of reducing and, if possible, eliminating all subsidies to parastatals by mid-1990, but subsidies could, and should, be completely eliminated by then; such an objective should not be tentative. In general, though, the summary and timetable in Table 2 was impressive in revealing the breadth of Senegal's reform effort, and that table could be used in other countries' documents. Table 3 was also helpful in acquiring a clear picture of the external financing anticipated, and that too might be used as a framework for providing information in other policy framework papers.

Specifically regarding the program for 1988/89, the slippage in wage policy was disappointing; an intensified effort in that area was critical during the period ahead, Mr. Dallara emphasized.

It was important that the authorities and the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO) keep the exchange rate under very close review, and that the Fund approach its analysis of program design in Senegal and other members of the UMOA with the same degree of close scrutiny, Mr. Dallara declared. The exchange rate was a powerful instrument of adjustment and it should not be ruled out. While the stability which the fixed exchange rate had brought to Senegal and other countries of the region was important, it was necessary to keep the issue under close review and recognize the implications that a fixed nominal exchange rate had for other policy instruments. In particular, it put a considerable burden on fiscal and wage policy, where there was little scope for further slippage.

The plan to reduce the number of government employees by 1.5 percent over two years represented slower progress in that area than in many others, Mr. Dallara commented. He hoped that a more ambitious target would be set in the next year's program.

The current producer price for groundnuts was obviously far above world price levels, Mr. Dallara said. He hoped that early and significant action could be taken to redress that problem, which had serious implications for the Government's fiscal position. Also, it was not clear that the strategy on cereal pricing was appropriate. Projected increases in the food import bill for 1988/89 and 1989/90 were cause for concern.

The decision to keep sugar prices unchanged for more than two years was fundamentally incompatible with the objectives of the program, Mr. Dallara said. In contrast to the energy price situation, it appeared that in the case of sugar, the high prices paid by consumers benefited a private monopoly and not the Government more generally. Progress in that area would have a significant impact on the Fund's judgment of any subsequent programs; the staff should put high priority on actions to end that monopoly very soon and move prices in the right direction.

Regarding agricultural pricing in general, as necessary adjustments were made in critical agricultural prices, those adjustments should be accompanied by a move toward price liberalization, Mr. Dallara considered. Greater flexibility in agricultural pricing could reduce the politicization of those prices and accelerate price changes.

While energy prices had played an important role in strengthening the Government's fiscal position, continued rigidity was not consistent with the broad objectives of the program, Mr. Dallara stated. On the assumptions in the recent World Economic Outlook, some adjustment in energy prices was to be expected.

Senegal had certainly made initial progress in parastatal reform, but the pace of adjustment could be accelerated, Mr. Dallara suggested. It would have been appropriate to incorporate some benchmarks regarding parastatal reform into the design of the structural adjustment arrangement and/or into the review clauses of the stand-by arrangement; he hoped that that would be done in the future.

The audit of the groundnut oil processing company, SONACOS, which was scheduled to be completed by the end of March 1988, should be a basis for action, Mr. Dallara emphasized. The program for the next year should build on that audit to ensure that SONACOS was making good use of the resources which it commanded.

While the efforts under way in the banking sector were welcome, perhaps they were not sufficient in light of the serious and widespread nature of the problems in that sector, Mr. Dallara remarked. He hoped that the authorities would intensify their efforts to deal with the many problems in the banking sector, with the Fund and the Bank both playing an active role in that process. For example, it was noted in the staff paper that supervision and control by the BCEAO would be strengthened. While that was desirable, the existing authority of the BCEAO, for example, to examine almost all loan documents and approve all loans above a certain threshold, should be used to the extent possible.

The planned elimination of quantitative trade restrictions by the end of the current year was welcome, Mr. Dallara said. In addition, he supported the elimination of reference prices and special agreements with certain enterprises, as noted in the objectives in the policy framework paper, although he would appreciate having more specific indications of the priorities and timing of such actions.

The fiscal reforms of 1987, involving a fundamental reform of the general tax code and a revision of the property code authorizing urban land sales by the Government, were welcome, Mr. Dallara said. The policy framework paper noted that various exemptions and preferential arrangements would be revised, but they were not explicitly referenced in the timetable, and he hoped that steps could be made in that direction in the near future.

On monetary policy, in light of the existing exchange rate regime, a more active interest rate policy was crucial, not only for Senegal but for other members of the UMOA, in order that other policy instruments could more actively facilitate the achievement of the program's objectives.

The medium-term scenarios provided a useful quantitative framework to supplement the analytical framework which had already been supplied by the staff, Mr. Dallara said. They also provided the structure for an early move, which would be in Senegal's interest, from continued reliance on the Fund's ordinary resources. The authorities were to be commended for the impressive efforts characterizing their performance in the last three to four years. He encouraged them to continue and intensify that effort in order to attain the growth path and payment sustainability for which they had been striving.

The staff representative from the African Department said that, while the authorities had indeed made major adjustment efforts since mid-1983, with considerable success, Senegal still faced a number of structural and financial problems. In the circumstances, the authorities had rightly opted to sustain their adjustment efforts on a broad front--a process which would not be easy. The Government was committed to reform in many fields, including the three major areas listed in the staff appraisal. There was, in Senegal, a group of senior officials in the economic and financial spheres which was very conscious of the problems and was willing to work toward appropriate solutions; the quality and resolve of those officials were reassuring.

The staff had been keeping exchange rate policy under review, with the discretion necessary in dealing with a convertible currency that was common to all members of the UMOA and the Central African Monetary Area, the staff representative noted. The monetary authorities had indicated that an exchange rate adjustment relative to the French franc was not ruled out; indeed, that possibility was mentioned in the statutes of the UMOA and in the cooperation agreement with France. However, in accordance with those provisions, an exchange rate adjustment could be envisaged only collectively and in consultation with France. Thus, individual members of the UMOA, such as Senegal, could not follow an independent exchange rate policy, although each member could of course influence its real effective exchange rate through its domestic policies.

The monetary authorities felt that there was no conclusive evidence of the need for a change in the peg to the French franc, the staff representative indicated. Although the nominal and real effective exchange rates for a number of countries had appreciated since 1983--and much attention was focused on that matter--there had been no significant real effective appreciation of the CFA franc on the basis of a longer time frame. That was due to the moderate rates of inflation in the UMOA relative to its trading partners, particularly other African countries.

Moreover, the member countries of the UMOA had continued to maintain an exchange system free of restrictions on payments and transfers for current international transactions, and there had been no obvious parallel markets for the CFA franc as such, the staff representative added. While the authorities were aware of the inconveniences of the existing exchange rate arrangement, they placed considerable weight on the advantages of a stable exchange rate for production, investment, and trade.

Fund-supported programs had put much emphasis on correcting the large public sector deficits--whether they were the deficits of the Central Government or those of public enterprises--since they were a major cause of the external imbalances in most UMOA countries, the staff representative continued. To that extent, the existing monetary arrangements had not overly restricted the choice of appropriate adjustment policies, particularly when the French franc had depreciated. In certain cases, including that of Senegal, fiscal proxies for exchange rate action had been used on a limited scale along the lines suggested by Mr. de Groote.

In view of the recent decline in world market prices of most major exports of the UMOA countries--for instance, cocoa, coffee, and groundnuts--and the appreciation of the French franc relative to the U.S. dollar, many of those exports were currently largely subsidized, placing renewed strains on public finances and an added burden on fiscal policy, the staff representative noted. For that reason, it was particularly important for those countries to constrain costs and bring inflation under control. Since unilateral exchange rate action was precluded, it then became necessary, for example, to reduce producer prices or to ensure a steady decline in real wages. The staff would continue to keep those complex issues under review; it had recently attended a symposium in Dakar in which a number of those issues had been raised, and while the discussions were not conclusive, they did suggest that the authorities were open to a policy dialogue.

The staff regretted the delayed action on producer pricing policy, the staff representative indicated. The study, which was to be conducted with World Bank assistance, had not been carried out in time, for the reasons indicated in the staff paper. In any case, action in that area, particularly regarding groundnuts, would have been difficult in view of the upcoming elections. The study had been recently undertaken, and the staff was awaiting the preliminary conclusions and recommendations of the consultants. The authorities hoped that the study would strike a balance between recommending incentives on the one hand and subsidies on the other. If the decision was to maintain incentives to groundnut producers, the elimination of the subsidy would be a problem. However, the farmer was not the only focus of reduced subsidies; the rationalization of the operations of the groundnut oil processing company--SONACOS--was also important. An audit of the company was to be conducted to assess ways to restructure its facilities in order to improve productivity and reduce costs. Suggestions had also been made for enlarging the company's capital and opening it up to private participation.

Under the revised agreement with the sugar company, the direct operating subsidies to that company would be eliminated by November 1987, the staff representative remarked. However, the company continued to maintain its monopoly, and the retail price of sugar was being kept at a very high level because of its sizable costs of production relative to the world market price. The result was that smuggling from neighboring countries was encouraged. The sugar company had begun implementing a modernization program designed to reduce costs and prices, and further actions were to be taken on the basis of an audit which was envisaged under the third structural adjustment loan from the World Bank. There had been some delay in carrying out that audit, but it was now expected to be conducted before the end of the year. The staff would keep developments in that sector under review, in close collaboration with the World Bank staff.

The authorities had taken some actions on banking sector reform, but a more comprehensive program was necessary to come to grips with the serious problems of a number of commercial and development banks, the staff representative said. To develop such a program, the authorities were envisaging a series of meetings with all interested parties, including Senegal's major bilateral and multilateral creditors. A long-term solution to the problems of the banking system in Senegal would require a combination of actions: a vigorous loan recovery effort; improvements in bank management; strengthening of the banks' capital and other resources; and rescheduling on appropriate terms of the excess debit balances of banks in the books of the BCEAO. In addition, to avoid the re-emergence of such difficulties, supervision and control of bank operations by the BCEAO should be intensified and strengthened. State interference in banking matters, which had contributed to some of the problems, should be avoided.

On energy pricing, under previous Fund-supported programs, steps had been taken to eliminate the subsidies to the oil sector, the staff representative said. As a result of the adjustments made in domestic prices and recent developments in world oil prices, the situation had been reversed and the Government was now receiving the benefits. It was difficult to pass the gains to consumers quickly, especially when the country was in a tight fiscal situation, but Fund and Bank staff had been keeping the matter under review.

While there had been some slippage in the medium-term objective for the external current account deficit, there was no slippage if one viewed the ultimate goal as being the elimination of exceptional financing by the end of the decade, the staff representative remarked. Given Senegal's heavy burden of interest payments, debt relief should serve not only to close the financing gaps, but also to ease debt service payments over the medium term.

The slippage in wage policy in 1986/87 was a source of concern, but corrective action in that area was under way, the staff representative said. While the staff had noted the comment that the redeployment policy in the public sector could be accelerated, there had been, in the discussion of the policy framework paper by World Bank Executive Directors, considerable opposition to a policy of redeployment that did not guarantee new jobs in the private sector.

As the World Bank had included a number of specific conditions on public enterprise reform in its second and third structural adjustment loans, the Fund staff felt that using benchmarks in that area might have resulted in accusations of cross-conditionality, the staff representative from the African Department concluded.

The staff representative from the Exchange and Trade Relations Department said that while membership in the French franc zone had certain advantages--for instance, it had resulted in a better inflation performance than had prevailed elsewhere--a fixed exchange rate policy nevertheless had implications for other policies. For example, in Senegal, the greatest pressure was to make timely improvements in costs.

It was questionable whether it was appropriate to subsidize export-oriented industries, even as a temporary, second-best solution, the staff representative commented. Even so-called temporary systems created vested interests and led to distortions, with the adjustment burden being placed more heavily on certain sectors of the economy. In particular, a drawback system, under which refunds were made of duties on imports intended as inputs for export production was undesirable, since the drawback scheme rigidified the input/output relationship in the export sectors, unlike an exchange rate adjustment which would make for more efficient use of inputs, specifically those of imports.

Mr. Dallara pointed out that membership in the UMOA was not necessarily synonymous with maintenance of the current exchange rate parity; one could question the current exchange rate without necessarily questioning membership in the Union.

Mr. de Groote said that there was no reason to doubt the authorities' intention to introduce subsidies or restrictions as a purely temporary measure. Their record in moving toward a market economy was admirable and the authorities' plans should be taken at face value. An additional advantage to the fixed exchange rate system to those mentioned by the authorities was that capital flight did not occur because of certainty in the parity with the French franc. Realistically, the authorities should not be reprimanded for plans either to increase the degree of restriction of their payments system or to use fiscal instruments to obtain an exchange rate advantage.

The staff representative from the Exchange and Trade Relations Department noted that the authorities' view that an exchange rate change was not necessary had implications for the cost structure, particularly of new investments. Large distortions could occur in that area if one accepted generally that fiscal measures could and should be a substitute for exchange rate adjustments.

The Acting Chairman commented that the issue raised was a practical one, with which the staffs of the African Department and the Exchange and Trade Relations Department, as well as the authorities, had to grapple. It was a matter of weighing the costs and benefits of some difficult alternatives.

Mr. Santos remarked that as Directors had observed, Senegal's exchange rate and interest rate policies had to be determined in the context of the UMOA. In that context, Mr. de Groote's statement to the Executive Directors of the World Bank had been helpful.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Senegal has requested a stand-by arrangement in an amount equivalent to SDR 21.275 million for a period of 12 months from October 26, 1987 through October 25, 1988.

2. The Fund approves the stand-by arrangement set forth in EBS/87/205, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 8714-(87/148), adopted
October 26, 1987

Structural Adjustment Arrangement

1. The Government of Senegal has requested the second annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Senegal in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper contained in EBD/87/245 (9/28/87).

3. The Fund approves the arrangement set forth in EBS/87/205, Supplement 2.

Decision No. 8715-(87/148), adopted
October 26, 1987

2. SPECIAL CONTINGENT ACCOUNT - OPERATIONAL MODALITIES

The Executive Directors considered a staff paper on the Fund's reserves and operational modalities of the special contingent account (EBS/87/178, 8/11/87).

The Acting Chairman pointed out that the principal operational question for decision by the Executive Board was the matter of the distribution of the amounts placed to the Special Contingent Account following the dissolution of the Account.

Mr. Hogeweg made the following statement:

The paper before us mainly addresses the exact modalities of the special contingent account established last June (EBM/87/90, 6/17/87), following a discussion of provisioning in the context of the Fund. The missing details on the circumstances in which the need for the Account may be considered to have disappeared and the subsequent distribution method will have to be filled in at some point. Nevertheless, we should face the reality that the need for the Account will not disappear in the foreseeable future--on the contrary--and therefore distribution will not be relevant.

The figures on arrears available in June were alarming--in comparison, the amount of SDR 26.5 million placed in the Account is minute--and since then, the problem has only worsened. Arrears of principal to the Fund by countries which currently have been declared ineligible will soon be higher than the Fund's reserves of SDR 1.2 billion. We are very concerned by this development. In its comments, the 1987 External Audit Committee noted the establishment of the Special Contingent Account. At the same time, the Committee recommended additional precautionary steps in the event that settlement of protracted arrears is further delayed, such as increasing the amounts placed to the Special Contingent Account.

The staff has announced in EBS/87/178 that it intends to return to the issue of future additions to the Account and the modalities applicable to those additions at the time of the next review of the Fund's income position. It is indeed necessary that the staff make recommendations on measures to secure the financial integrity of the Fund and that the Board discuss them at an early stage. Of course, the decisions will be very difficult. We cannot expect an excess of net income over the target, which can be placed in the account relatively painlessly, to occur every year. Furthermore, we should not continue to put amounts in the Account on an ad hoc basis, based on the results of a given financial year. On the contrary, we need a set of rules that would link additions to the Account, in some predetermined way, to the arrears situation as it develops. This can either be done specifically, namely, by country, or generally, related to all countries in arrears. In any event, the reality of the arrears and the necessity to make some form of provision against them must be recognized.

At the June discussion on provisioning (EBM/87/87), this chair expressed the view that the necessary provisioning should be financed, as far as possible, by applying the principle of burden sharing. This view has not changed. While one could argue that it is the debtors who cause the arrears, and hence the amounts to be placed in the Special Contingent Account should be generated by an increase in charges, that argument would ignore the fact that the only debtors who would be contributing to the Account would be those that do pay their charges, and consequently do not contribute to the arrears. For this reason, and in the cooperative spirit of the Fund, a contribution by creditors seems warranted. In this context, it seems logical that the modalities of the Special Contingent Account require the principle of burden sharing to be applied when the amounts placed to the Account are distributed to members after the need for it has disappeared; this was already set out in the June decision. Therefore, both debtors and creditors should share in the hypothetical distribution of the first amount placed in the Account, or alternatively, the amount could be added to the Fund's reserves. A judgment on the adequacy of reserves at the time of distribution is of course not possible at present.

Most important, we should decide on the modalities of the Account established last June with a view to the future, in that they should be applicable to possible future additions to the Account. We should avoid establishing a series of special contingent accounts in different financial years.

While the possibility of redistribution seems remote at present, our decisions on the modalities are important insofar as they have a bearing on how we will handle the arrears problem and on the financial integrity of the Fund. In view of these considerations, perhaps a decision on the hypothetical redistribution could better be taken after a discussion on the handling of the arrears problem.

I agree with the criterion put forward by the staff on when the need for the Account may be considered to have disappeared; I sincerely hope that this criterion may soon be applicable.

In response to a question by Mr. Nimatallah, Mr. Hogeweg said that he believed that additions to the Special Contingent Account should be made to the original single Account, but that redistribution of the funds in that Account in the future would have to be made according to the contributions in each financial year. Therefore, a decision would have to be made as to which part of the Account would be used first, and consequently which portion would be redistributed first.

Mr. Nimatallah asked the staff how, if the amounts of overdue obligations decreased, the redistribution would be determined.

The Treasurer said that there were two ways of treating allocations to the Account in different years on different terms. First, a separate special contingent account could be created for each year that an allocation was made, irrespective of the terms on which the contributions were made. Second, different modalities could be applied to different allocations to a single contingent account. There was no necessity for a separate account for each year, but it would be essential, if there was only one Account, for the Fund to keep accurate records of the origin and use of the amounts placed to it in different years, for purposes also of redistribution.

Mr. Nimatallah made the following statement:

> There are three schools of thought in the Board concerning the response of the Fund to the growing problem of overdue obligations.
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> One school contends that overdue obligations are a temporary problem, and that therefore the Board should not worry much about them; the problem will eventually take care of itself when member countries succeed in putting their houses in order. This school obviously has confidence in overdue members, and believes that they are responsible and will eventually settle their overdue obligations.
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> The second school of thought is concerned about arrears, but believes that the Fund is a special, cooperative institution that should not adopt measures such as provisioning, like commercial institutions, but instead should increase existing reserves at a faster rate. This school contends that if the Fund makes provision for overdue obligations related to the magnitude of the problem, by setting specific ratios, the countries in arrears will not react responsibly because they would lose the incentive to repay their obligations.
>
> The third school of thought is not only concerned about the overdue payments problem, but also wants to do something to correct it by following normal financial practices. Because the Fund is a financial institution, this school believes that sound financial management requires recognition of the problem, and the taking of precautionary steps to eliminate it. This school not only believes, as do the External Auditors, that the Fund should make provisions, but also feels that it should establish a clear relationship between the size of overdue obligations and such provisions.

The Board, in its wisdom, established the Special Contingent Account and put in it, during fiscal year 1987, SDR 26.5 million. The External Auditors reacted favorably to that decision. We now have a compromise account that can be satisfactory to all groups, as it seems to satisfy the External Auditors, those who ask for provisioning, those who do not want provisioning, and even those who do not want to do anything about the issue of overdue payments, in the sense that any amounts put in this Account are supposed to be refundable if the overdue payments decline and disappear.

I, for one, think that this Account is well designed, in the sense that it is not related directly to the overdue amounts in any specific way, neither by country, by length of delay, nor as a ratio. However, as shown in Attachment II to the staff paper before us, the External Audit committee made the following appeal in its comments to the Managing Director:

> In the event that settlement of protracted arrears is expected to be further delayed, further precautionary steps should be taken perhaps by increasing the amounts placed to the Special Contingent Account, to compensate for the effect of such overdue obligations on the Fund's financial position.

The question is how to react to this appeal, by increasing the amounts placed to the Special Contingent Account, as the overdue payments problem is worse today. I would suggest that the Board take a decision that any surplus income expected for fiscal year 1988 be diverted fully to this Account. However, I understand from the Treasurer that, unfortunately, no such surplus is expected in 1988 in light of the prevailing rate of charge. Therefore, I propose that the 2 1/2 percent burden-shared increase in reserves--on top of the 5 percent agreed to in the existing burden-sharing decision (Decision No. 8515-(87/22), 2/16/86), be diverted to the Special Contingent Account, leaving only 5 percent to be added annually to reserves, as agreed originally.

I also suggest that the Board take another decision to increase net income by another 2 1/2 percent, burden-shared, for 1988--in addition to the net income target--to be placed to the Special Contingent Account. I believe that adding about SDR 50 million--the equivalent of 5 percent of reserves--to the Special Contingent Account should be considered a further precautionary measure, and therefore would be satisfactory to the External Audit Committee.

When the present burden-sharing decision is reviewed for fiscal year 1989, the Board will have a range of options to choose from, in light of the state of the overdue payments problem at that time. For example, if the problem subsides, this additional 2 1/2 percent increase could be canceled, leaving only the existing 2 1/2 percent burden-shared increase to be diverted to the Special Contingent Account. However, if the problem worsens by that time, the Board might opt for not only leaving the 5 percent burden-shared increase to be added to the Special Contingent Account, but also perhaps to divert 2 percentage points from the 5 percent that is paid for only by the borrowing members. The end result would be that 7 percent would be added to the Special Contingent Account, and 3 percent would continue to be added to ordinary reserves. There must be enough flexibility to easily divert increases created by additions to net income to and from the Special Contingent Account and reserves.

The refunding of these amounts in the future should take place when the need for these amounts declines with a decrease in the size of overdue payments. When that happens, refunding should be according to the amounts paid by each member in each particular fiscal year, whether that is in accordance with the burden-sharing principle or not. However, even when amounts in the Special Contingent Account decline to zero, either because they were refunded or returned to reserves, the Special Contingent Account should not be terminated. In case the overdues problem returns, it would be easier to add amounts to the Account than to re-establish it; there is no harm in maintaining an inoperative account.

Mr. Foot remarked that Mr. Nimatallah's characterization of the Account reflected the view that many Directors had taken in approving its establishment. Yet it appeared from the staff paper that the potential uses of the Special Contingent Account had been left too vague. In paragraph 12 in Section III, the staff noted that "the stipulation in the Decision that the amount shall be distributed, when the need for the Account disappeared, to creditors and debtors for that year would seem to preclude attribution of the amount to the Fund's reserves." If the amount could not be attributed to reserves, then presumably neither could it be used for provisioning. In that case, what could the Account be used for?

Mr. Goos remarked that while Mr. Nimatallah's suggestions were of interest, he had expected to discuss only technical questions at the current meeting. Accordingly, he was not in a position to discuss the future role of the Special Contingent Account.

Mr. Zecchini said that he was in agreement with Mr. Goos's point, in that he was prepared to discuss only the specific issue before the Board, and not full-fledged provisioning. His position was based on the indication in the staff paper that "with regard to possible future additions to the Account, the staff will come back to this issue at the time of the next income review." A far-reaching discussion was not appropriate at the present time.

Mr. Nimatallah remarked that he had understood the staff in its paper to be asking for the Board to take the lead and to provide guidance for the future handling of the problem of overdue obligations. Apparently, the creation of the Account had been helpful; it had satisfied the External Auditors who, however, were currently requesting that further precautionary measures be taken as the problem of overdue payments had become worse. The current discussion was an opportunity for the Board to exchange views with the issue of principle and the technical issues involved in strengthening the Account.

Mrs. Filardo said that in the original decision establishing the Special Contingent Account, it had been decided that if the Account was no longer needed, the amount would be distributed in accordance with the principle of burden sharing. Accordingly, she felt that the present discussion should concentrate on the methods of the operation of the Account, and not the modalities of its distribution.

Mr. Foot said that while the Board was not expected to take decisions at the current meeting, no progress at all would be made unless Executive Directors aired their ideas on the general subject. The initial response of the staff would also be helpful.

Ms. Bush agreed that it was important for Directors to present their opinions on the arrears situation and how the Fund's financial position could be protected, with reference to the Special Contingent Account in particular. In the staff paper, in addition to the two procedural issues, guidance was sought regarding the impact on the desirable rate of reserve accumulation of the establishment of and placement to the Account. The implication was that the staff expected to hear the views of the Board on the continued buildup of that Account and on the protection of the Fund's financial position. At EBM/87/90 (6/17/87) the Managing Director had suggested that the current meeting, which had been expected to be held in July, would cover the modalities of the Special Contingent Account and related issues raised by Directors during the previous week's discussion on overdue obligations and provisioning. It was essential that the substantive issues be discussed at the current meeting.

Mr. Fogelholm said that he also felt that a broader discussion of the issues was useful, especially as formal decisions were to be taken at a later stage. He asked the staff whether, from the point of view of the Fund, there was a difference between use of a Special Contingent Account and reserves, in the unlikely event of a formal default by a member.

The Treasurer said that the staff had hoped for a decision on the alternative modalities upon the dissolution of the Account once overdue obligations no longer existed. First, such a decision would complement the decision taken by the Board at EBM/87/90 and second, it would be highly desirable to make clear who the beneficiaries would be of the amounts distributed from the Account.

If the Board were to come to the decision that the Fund was suffering a loss from the incidence of overdue financial obligations to the Fund, the relevant amount would be charged against the Account, thereby protecting the Fund's income position, the Treasurer added. The balance remaining in the Account once the Board found that the problem had been overcome would then be available for distribution to member countries, in a way which the staff had hoped would be decided at the present meeting.

The difference between the Special Contingent Account and reserves had been discussed extensively among the staff and by the Board when the question of provisioning in the context of the Fund had been considered at EBM/87/87 and EBM/87/90, the Treasurer said. A Special Contingent Account was a nonreserve reserve, whose role fell between that of provisioning, as done by commercial banks, and that of reserves, which were established and added to by the Fund from its net income every year. The Board had established the Account, in recognition of the special risks the Fund was facing in connection with overdue financial obligations, and it could decide to call upon that Account, as needed, to cover any loss the Fund would suffer stemming from overdue obligations. Without the Special Contingent Account, funds would have to be withdrawn from the Fund's operational income. If that withdrawal led to an operating deficit in the financial year concerned, then that deficit would have to be covered by recourse to the reserves. The specific way in which the reserves were drawn upon would depend on other elements of the Fund's income position in that particular year.

Mr. Nimatallah commented that as he saw it, reserves covered deficits in income--or the profit and loss account, if there was one--whereas the Special Contingent Account covered asset loss directly, without the need to resort to the use of reserves indirectly, through income.

Mr. Zecchini considered that it was not necessary to reopen the discussion on the basic principles of the Account. According to the staff paper, one of the main purposes of the Fund's reserves was to provide some protection against impairment of the Fund's subscribed assets. Previously, the staff had suggested that the major difference between reserves and a special contingent account in that respect would be the impact on the two ways of sheltering the financial position of the Fund of tax treatment, which was not relevant for the Fund because it was not a profit-making corporation. The Fund's pricing policy was based on achieving a certain target over net accretion to reserves.

Mr. Sengupta agreed that the issue had already been fully covered. Since there could be no impairment of the Fund's assets, only reserves were relevant for an institution like the Fund. Provisioning was necessary only when the tax element was present. He saw no operational difference between reserves and the Special Contingent Account.

Mr. Nimatallah said that the Special Contingent Account was a responsible way of diverting reserves for a particular purpose, without waiting for potential losses to materialize that would then have to be covered out of income. The establishment of the Account had been a good financial management decision.

Mr. Seyler made the following statement:

During this Board's discussion of the income position for FY 1987 and FY 1988, it was rather unexpectedly decided, with support from some middle-income countries, to open a Special Contingent Account, even though only a few days before, during the discussion on provisioning, the idea of opening a special account had found only a few supporters.

These background facts are not brought out in the staff paper, which gives the impression that there was broad support from the beginning for creating a special account.

Furthermore, the Managing Director reassured one of us at the end of the income discussion that the decision to create a special account was to be dealt with separately from the question of provisioning and would have no effect of future discussions of provisioning. Now, however, the global approach chosen by the staff in today's paper lumps the Special Contingent Account together with provisioning by earmarking certain sums for the problem of arrears.

Concerning the two specific questions the staff has addressed to the Board, we take the following positions: in order to provide the Board with some flexibility, we support the position that the need for this account should be deemed terminated when the problem has essentially been solved. Concerning the future distribution of the amounts placed in the Special Contingent Account, we take the position that in the absence of arrears to the Fund, the Board would have lowered retroactively the rate of charge to the level which in retrospect would have achieved the agreed net income target. Thus, I favor repayment to the Fund's debtors of the monies now in the account, at the time when the circumstances leading to the account's creation shall be deemed to have disappeared.

Mr. Sengupta made the following statement:

When the decision was taken in June to establish a Special Contingent Account, using about SDR 26.5 million from the excess income of FY 1987, this chair clearly stated that the establishment of such an account could take place only after a thorough discussion of the adequacy of reserves in the light of various considerations, including overdue financial obligations to the Fund. The consensus view in the Board then was for setting up such an account and for having full discussions on the adequacy of reserves at a later date. The Special Contingent Account was created, according to the Chairman's summing up, first, "in the light of the recent review of the overdue obligations," and second, "owing to the necessity to close the Fund's accounts for FY 1987." The second reason is uniquely related to the past year. Regarding the first point, it is true that there has been a marked increase in overdue financial obligations, and that there has been a considerable fall in reserves in relation to arrears and to credit outstanding to members with protracted overdue payments. The question is whether a solution to this problem calls for a further increase in the level of precautionary balances, and if so, whether that increase should be in the form of reserve accumulation or placements to the Special Contingent Account.

The matter of increasing the level of precautionary balances should be considered with reference to the nature of the Fund, the total size of reserves, and the protective actions taken since the Board decided to raise the Fund's net income target from 3 percent to 5 percent in June 1985. The total amount of such precautionary balances has risen by about 18 percent since 1985. This indicates that we have kept a close watch on possible threats to the Fund's financial integrity. We have also decided to continue the policy of adding to reserves of 7.5 percent net income for FY 1988. The purposes of building reserves as presented in the 1985 staff memorandum have all been fulfilled as summarized on page 2 of EBS/87/178: reserves have contributed to the Fund's liquidity; the Fund's financial affairs have been demonstrated to be soundly managed; and some protection against impairment of the Fund's subscribed assets has been provided. In the latter respect, the word to note is "some"--neither "full" nor even "substantial" protection was mentioned. Indeed, if a well-structured approach to overdues is developed evolves, the present level of reserves could itself become too large. A financial institution's business is to lend and not to build reserves. Also, we should not forget the fact that an institution that has sovereign governments as members and is built on international cooperation should have little need for very large reserves. The staff admits that a number of criteria should be considered for judging the adequacy of the Fund's reserves, and that no one criterion should be of predominant importance to the exclusion of others. There is therefore no reason, in deciding on a further increase in precautionary balances, to give primary consideration to overdue obligations and the amount of credit outstanding to members in protracted arrears.

Let me elaborate a little further. I am in no way minimizing the importance of overdue obligations--indeed, we are extremely concerned about their growth and the fact that very little has been done to solve the problem. But building reserves is no solution, and alternative ways have to be found to deal with it. This chair has always maintained that our overdues problem is not general, but specific to a few countries. It has been a serious problem since 1985. Throughout the period from September 30, 1985 to June 30, 1987, six countries--Guyana, Liberia, Peru, Sudan, Vietnam, and Zambia--have accounted for about 85 percent of overdue obligations. In fact, in June 1987, they account for about 97 percent. I am afraid that, for at least four of those countries, the only solution is for donors to help them repay the Fund in exchange for the adoption of adjustment programs. On their own, they will not be able to make the payments, simply because they do not have the assets that would yield the requisite returns. The solution has to be based on prospective policies that would correct the situation in the future. For the present, either the donors have to pay for them, or the amounts will have to be carried in the Fund's books indefinitely, since the Fund's Articles in effect do not allow either "write-off" or "formal default." There is no contingency or reversibility in this latter event, and reserves provide no protection in such a situation.

We spent a considerable amount of time in discussion in June without agreeing to provisioning, which would require an establishment of probably loss of Fund assets that is not feasible, on legal and other grounds. The Special Contingent Account is not a mechanism for provisioning, but another way of increasing reserves. Whether an addition is made to this Account or not would depend on what we do about reserves, which we shall discuss at the time of the next income review. At best we can say that this Account is related to one of the criteria for an increase in reserves, namely, overdue obligations. The need for the Account would disappear, if we go by the 1986 discussion on burden sharing (EBM/86/124), when there were no outstanding charges or repurchases or "at such time as the Fund may decide."

As regards distribution of the proceeds in the Account, which is the question we have to decide today, I still believe that the rate of charge in FY 1987 was so fixed that it produced excess net income. While the estimates of income and expense may eventually turn out to be different at the end of the year, the target net income is the decisive element in the fixing of the rate of charge. As such, the rate of charge should be reduced since the members in debtor positions had to bear the additional charges that brought about the excess income.

> That is the method by which the Fund's accounts are ordinarily settled, and it underlays the arguments in paragraph 13 of the staff paper for an alternative solution to the distribution problem. Given the increase in the reserve target as a variable, the Fund's income and expenses are functions of the rates of charge and remuneration, after projecting the actual figures for the other components of expenditure. The rate of remuneration is taken as a parameter, decided upon separately and invariant to the operations of the Fund, and the rate of charge is therefore the only adjusting variable. That method is not compatible with the suggestion that amounts be paid back to creditors as well as debtors on the ground that an unambiguous attribution to a specific source cannot be made for the amount. What is relevant is the method adopted. The main argument for that suggestion has been provided by some Directors. The question is which factors or variables are regarded as "targets," and "parameters," and which are regarded as "adjusting" or "equilibrating" in order to balance the Fund's income position, which was of course affected by many factors. I propose that, henceforth, any surplus that results from higher than projected income be distributed equally to the creditors and debtors, by adjusting the rates of both remuneration and charges, provided that any deficit that results from lower than projected income also be distributed likewise. If this is not agreed to, there can be no basis for suggesting that the amounts in this Account should be shared between creditors and debtors; in that case it should be used wholly to reduce the rate of charge.

Mr. Marcel said that his authorities did not consider it a matter of urgency to take a decision at the current meeting. If the Board was not in a position to reach an agreement because some differences of views persisted, they had no difficulties in maintaining the Account on a temporary basis. Nevertheless, he could express the preferences of his chair, if conditions did exist for terminating the Account. Any solution leading to a transfer from the Special Contingent Account to the General Reserve must be dismissed. Such a solution would be equivalent to establishing provisions, which the authorities still considered politically and technically unacceptable. The funds in the Account came, at least in part, from the overvaluation of the rate of charge, which was established in accordance with the rate of renumeration paid to creditor countries, the projected amount of expenditure, and the net income target. It was clear, therefore, that any overestimation of expenditure would automatically result in an overvaluation of the rate of charge. That was why the rate of charge was currently higher than the interest rate of the SDR. Consequently, the distribution of the amount placed in the Account in FY 1987 should be made to the debtor countries, and not shared between debtor and creditor member countries in a simultaneous and symmetrical fashion. Such a solution would constitute an unwarranted extension of the burden-sharing scheme.

Mr. Fogelholm said that he was in favor of disbursing the amount placed in the Account in FY 1987 to the debtor countries alone, based on the assumption that the rate of charge had been excessive because the income target had previously been fixed and agreed upon, and also because most of the Fund's income came from charges. He did not take a stand with regard to any amount which would be added to the Account, as he felt that the Account itself was not necessary. Also, it would create a strange situation if the Fund created a contingency fund based upon excess income generated only from the use of resources by member countries which were indebted to the Fund and able to make timely repayment; no contributions would be made by those countries which did not have any obligations to the Fund, not to mention those who could not repay their obligations. That was not an example of fair burden sharing.

Mr. Nimatallah said there were two issues to discuss under the question of refundability: the distribution of the SDR 26.5 million already in the Account, and of any amounts which might subsequently be added according to the principle of burden sharing.

Ms. Bush made the following statement:

> The staff paper raises three issues for our discussion: first, the circumstances in which the need for the Special Contingent Account might disappear; second, the method for distributing the proceeds of the account; and third, the impact of the Account on the Fund's reserve accumulation. The more basic issue confronting us is what further steps to take in light of the growing arrears situation, steps which should be shaped around further protection of the Fund's financial position, and which therefore must address reserves and the further building of the Special Contingent Account. We need to consider this fundamental issue having before us a thorough review of the issue along with options for consideration. I note that on page 9 of the paper before us the staff has indicated "with regard to possible future additions to the Account, we will revisit this issue at the time of the next income review." I look forward to that and believe it very important that we have a series of options to consider at that time. This Special Contingent Account was specifically established "in view of the existing overdue obligations" and in this respect we believe that additional amounts will need to be placed in the Account.
>
> The decision to establish the Account was also taken against the background of lengthy discussions and very serious concerns raised by the Board about the overdue situation, with the Board emphasizing that the financial position of the Fund must be kept unquestionably strong. Moreover, the 1987 External Audit Committee's comments to the Managing Director and the Treasurer stated that further precautionary steps were needed, such as increasing amounts in the Special Contingent Account, and concluded that substantial progress was needed on this front prior to the 1988 external audit.

The need to strengthen the Fund's financial position has become all the more pressing in view of the continued deterioration in the relationship between arrears and reserves and the absolute growth of arrears. Since the establishment of the Special Contingent Account, arrears have risen further; our fundamental problem has grown. The Fund's repurchase arrears have increased, since the end of the previous fiscal year, from SDR 845 to SDR 1.1 billion. This brings total arrears to SDR 1.4 billion, which will certainly grow if those members in arrears are unable to reduce present arrears and meet obligations coming due.

While precautionary balances--reserves--have increased, the basic question is whether they are building enough in light of the size of the arrears problem and the quality of assets. Mr. Sengupta has said, and I agree, that donors must help with this problem. In fact, some donors have been making efforts to try to address the problems of some members in arrears, but most of these efforts have not yet come to fruition. Despite those welcome efforts, it is incumbent upon us to further protect the Fund's financial position. We do, therefore, believe that the amount placed in the Special Contingent Account should be augmented; this should be done on a more structured basis than was the case last year. We need guidelines on precisely how the Account will be built and how it will specifically relate to the buildup of arrears.

The next most pressing business is how to build this Account that was established specifically in light of overdue obligations. In conjunction with that, we also need to consider our general reserve position. As implied earlier, a series of options are needed for the Board to consider. Mr. Nimatallah has given some interesting ideas for adding to the overall amount of Special Contingent Account and reserves. While I cannot comment at this point on the specifics of Mr. Nimatallah's proposals, in general, his suggestions regarding increasing the Account have some attraction, as we do believe it should be increased. Also, we would need to know specifically how this formulation would relate to the actual size and prospects for arrears. In the forthcoming work from staff, we would appreciate further reflection on Mr. Nimatallah's suggestions and on other options.

With regard to the issues of dissolution of the account and who should be the recipients of distributions, in general, I think it much more important to first tackle the issue of how we will build this Account, and the related issue of reserves. These more basic issues should be considered before discussing what will happen when the Account is no longer needed. Regrettably, it does not seem that the date of no longer needing the Account will be upon us in the near future. However, I believe that we could eventually draw up some guidelines related to what circumstances would dictate that the Account is no longer needed. Those guidelines should center around the weight of the arrears situation in the Fund. For example, when arrears are no longer in existence, the Account might be significantly reduced, if management and the Board were then satisfied with the adequacy of existing safeguards to protect the financial position of the Fund.

As for how amounts in the Account should be utilized when it is no longer needed, we also need some guidelines as to what our options are, giving due weight to the source of the contribution.

As for the SDR 26.5 million already in the Account, the Board has indicated it would like to follow the principles of burden sharing, which implies redistribution. Arguments in the staff paper seem to point at one time to both creditors and debtors sharing, and at another time toward just the debtors receiving this amount. Until I can get a clearer view of this, I do not believe I can express a considered opinion. In any case, as I have said at the beginning, I do not believe we should be deciding this today prior to coming to grips with the more serious problem of how we build on the SDR 26.5 million. Perhaps when we come back to that subject at the midterm review, the evidence might become somewhat more transparent as to who should be recipients of the SDR 26.5 million when the Fund is in the fortunate position of no longer needing a Special Contingent Account.

Mr. Zecchini made the following statement:

My position on this issue is quite straightforward; it follows the considerations I have developed in the past few years on the issue of overdue obligations vis-à-vis the Fund and the Fund's financial integrity.

At this time, there is no need either to distribute or to transfer to reserves the resources in the Special Contingent Account. The reasons that prompted the establishment of this Account four months ago are still with us; overdue obligations continue to rise to record levels.

There is no certainty about the origin of these resources; they can be attributed to a number of factors, including the rigidity of both the rate of charge and the rate of remuneration in FY 1987. The rigidity of the rate of remuneration below the SDR rate should not be forgotten.

We already have a decision by the Board on how the amount should be distributed. At EBM/87/90, it was decided that it would be distributed to creditors and debtors for 1987 in accordance with the principle of burden sharing, when the need for the Account disappeared. I still adhere to that decision.

The real issue, if there is one in this discussion, is when the need for the Account might disappear. There is no clear-cut criterion for this eventuality unless we accept the notion of a provisioning account, which I do not find fully justifiable for the reasons I have repeatedly stated in past Board meetings. But given this premise, a reasonable criterion could be to distribute the amount when all the arrears which accrued in FY 1987 are settled. This is consistent with the fact that the beneficiaries will be those countries, both creditors and debtors, that were affected by the rise in arrears.

As to the possibility of future additions to the Account, these would institutionalize provisioning against arrears, while the present Account has more the characteristic of an exception, as the name Special Contingent Account seems to suggest. I think that a decision on this issue should be taken only after the staff, at the time of the next income review, has presented a paper on these aspects.

Finally and incidentally, I would like to add to what I said earlier that an additional difference between the reserve accumulation approach and the provisioning approach is the refundability feature. Funds in the provisioning Account could be refunded directly to the original contributors, while in the case of the reserve approach, refunds benefit the original contributors only indirectly.

Mr. Finaish made the following statement:

Let me first recall the fact that this chair did not favor the establishment of the Special Contingent Account. But it is now in existence, and the Board has to decide on the two issues presented by the staff for its consideration.

Regarding the first issue, namely, the conditions for terminating the Account, we agree with the staff that it would be reasonable to apply the same criteria that govern the refunding of supplemental income. We also agree with the staff's interpretation of the term "or at such time as the Fund may decide." Clearly, the Board should have the flexibility of terminating the Account before overdue repurchases are totally eliminated. What is important is to reach a point at which a judgment could be made that the magnitude of the problem has been reduced to an inconsequential level.

The second issue relates to the distribution of the SDR 26.5 million upon the dissolution of the Account. Since the likelihood of the Account being dissolved soon is rather limited, the present discounted value of that money is probably quite small, and thus the matter of distribution should be kept in perspective.

On the other hand, it could be argued that the issue is one of principle, with possible implications for the distribution of other funds that might be added to the Account in the future. Be that as it may, the issue of the distribution of the SDR 26.5 million has to be settled by the Board. In our view, the balance of the arguments for the two options contained in paragraphs 12 and 13 of the staff paper tilts in favor of the latter--namely, that the amount in question should be distributed to debtors when the Account is terminated. It is true that the decision of June 17, 1987 states that the SDR 26.5 million shall be distributed to creditors and debtors, but the critical phrase in that sentence is that the distribution shall be in accordance with the principles of burden sharing. As we understand it, burden sharing involves two main principles: first, that the financial consequences--or costs--of overdue obligations should be shared equally between debtors and creditors: and second, that the refunding of those costs should go to those countries which have borne them.

If one were to distribute the SDR 26.5 million equally between debtors and creditors, this would imply that the burden of contribution in the first place had been shared equally. But that was not the case, since the money came from income which exceeded the level targeted by the rate of charge. As the staff points out in paragraph 13, given the agreed remuneration coefficient, perfect foresight would have resulted in a lower rate of charge needed to achieve the agreed income target. Thus, it is difficult to see how the SDR 26.5 million could be considered as having been financed equally by debtors and creditors.

Obviously, if the Board decides in the future to appropriate funds for the Special Contingent Account before the beginning of a fiscal year, the funds could be generated equally from debtors and creditors, with a provision for equal distribution upon termination of the Account, as has been the case with supplemental income in FY 1987 and FY 1988.

Looking into the future, in the event that the Board decides to keep augmenting the Special Contingent Account, it would be useful to avoid a situation in which additional amounts are generated in different ways and thus distributed in different ways. The system is already becoming quite complicated, through no fault of the staff since compromises in the Board have contributed substantially to that complexity. Perhaps a little more emphasis should be given to the desirability of a simple and transparent system.

Mr. Hospedales said that in view of the seriousness of overdue obligations, the Fund had instituted a number of preventive and corrective measures--including improved dialogue with those members actually or potentially in overdue status--all of which had served to limit the problem to a core group of countries. He associated himself with Mr. Sengupta on the types of initiatives necessary for the resolution of the problem. Equally important, a number of financial mechanisms--reserve growth, burden sharing, special charges, and nonaccrual of charges--had ensured that the Fund's financial position and integrity were protected.

It was appropriate that the debate on the factors to determine further reserve growth and, for that matter, provisioning, had not been reopened, Mr. Hospedales remarked. Conditions had not warranted the temporary placement of SDR 26.5 million of excess income, derived essentially from an overestimated rate of charge, to a new Special Contingent Account, particularly since the Account's resources stemmed from the Fund's failure to adhere closely to the procedures established in the regulations for utilizing excess net income, such as an additional retroactive reduction of the rate of charge for FY 1987--a decision which would certainly have been in the interest of the entire membership.

The agreed target net income could, therefore, have been realized with a lower rate of charge, Mr. Hospedales pointed out. Hence, the SDR 26.5 million placed to the Account in FY 1987 had been generated by Fund debtors, and in accordance with the principles of burden sharing, the amount remaining in the Account should be distributed to the debtors, who were responsible for generating the net excess income.

Mr. Foot remarked that it seemed as if the Board had created an account with no obvious owners, no idea when the money in the account would be repaid, and no clear agreement on what the account could be used for. All those issues were difficult.

On the dissolution of the account, the phrase "when the need disappears" was appropriate, since the issue should be decided judgmentally, and not mechanically, Mr. Foot declared. In any case, a lack of need would not occur in the foreseeable future.

While he felt that the rate of charge was indeed the marginal variable and, therefore, the funds in the Account did belong to the debtors, Mr. Foot said that he was concerned about the consequent legal implications of using any of the money in the Account. If it were decided that that amount belonged to the debtors, how could the Board then, as a group, decide on any particular use of it? Therefore, he would abstain from offering an opinion on the question of distribution.

It appeared that, if there were several separate contributions to and varied uses of the funds in the Account, the records would become extremely complex and difficult to manage, Mr. Foot remarked. If the Account's thought was of as a war chest, sensible uses could be found for the money.

His authorities remained strongly opposed to provisioning in any form, and they viewed the target rate of reserve increase of 7.5 percent as adequate, Mr. Foot said. In the second half of a financial year, it was preferable to aim high rather than low, and 7.5 percent was a minimum figure to aim at; if excess income resulted, all possible uses for it could be considered, including the building up of the Special Contingent Account.

Mr. Ismael said that he was supportive of a policy that could provide more precautionary balances to protect the Fund's financial position, as well as its annual income. In light of the persistently large overdue obligations to the Fund and the substantial exposure of the Fund to member countries' protracted payment problems, the present policy of targeting net income at the higher rate of 7.5 percent was appropriate.

He agreed with the staff's suggestion that the same criteria be applied to the eventual dissolution of the Special Contingent Account as would have governed the distribution of the supplemental income collected in accordance with the decison on the principles of burden sharing if it had been decided to generate such "supplemental income" for FY 1988, Mr. Ismael indicated. When there was reasonable evidence that the problem of overdue obligations had largely been overcome, the amount, or a part of the amount, in the Account should be distributed to members. On the sum of SDR 26.5 million from the excess income of FY 1987, which was to be placed in the Account, that surplus was an outcome of the overestimation of the interest rate trend when the rate of charge was set at the beginning of FY 1987. The benefit of that unanticipated downturn in interest rates should accrue to borrowing member countries.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/147 (10/21/87) and EBM/87/148 (10/26/87).

3. BAHRAIN - TECHNICAL ASSISTANCE

In response to a request from the Bahraini authorities for assistance in assessing present trends in the financial sector with a view to improving the long-term prospects, the Executive Board approves the proposal set forth in EBD/87/268 (10/20/87).

Adopted October 23, 1987

4. CENTRAL AFRICAN REPUBLIC - TECHNICAL ASSISTANCE

In response to a request from the Central African Republic authorities for assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/87/263 (10/15/87).

Adopted October 21, 1987

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/87/223 (10/19/87).

Adopted October 21, 1987

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/226 (10/20/87) and EBAP/87/227 (10/21/87) and by an Advisor to Executive Director as set forth in EBAP/87/226 (10/20/87) is approved.

APPROVED: May 17, 1988

LEO VAN HOUTVEN
Secretary